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Why Now is the Time to Get Out of Fixed Income Mutual Funds

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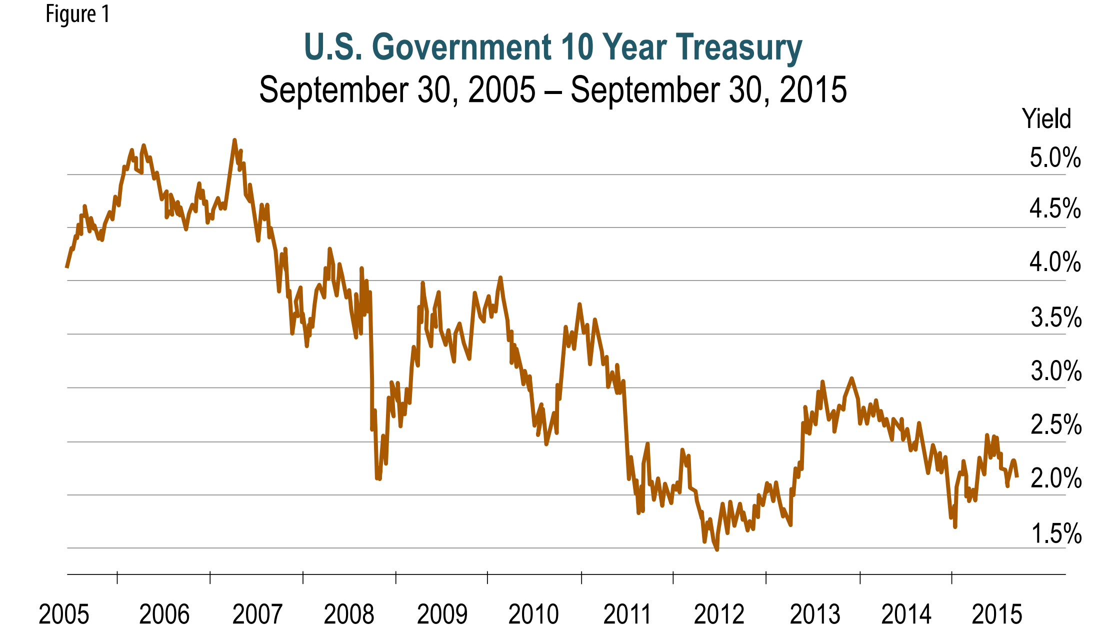
During 2015 thus far, U.S. Treasuries and other high quality bonds experienced volatility as the 10 year Treasury note yield has traded between a 1.64% and 2.48% versus a 2.17% at the end of 2014 (figure 1). The Federal Reserve left rates unchanged at their last meeting on September 17th. In their policy statement, the Fed remarked that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." However, it is expected that the Federal Reserve will begin to tighten monetary policy before the end of 2015 or early 2016, unless unforeseen events occur to alter the Federal Reserve's expected path. During monetary tightening cycles, interest rates generally rise and normalize to higher yields.

Figure 1



Source: Bloomberg

With interest rates still at historically low levels, now is the time to hold individual bonds to weather an eventual rise in interest rates. Holding individual bonds, as opposed to mutual fund shares, allows the bondholder to ride out the rise in interest rates, collect income, and wait until maturity to get back a bond's principal. In addition, owning individual bonds provides the investor full transparency as opposed to fixed income mutual funds, which may even hold stocks. For investors with sufficient investable assets, opening a separately managed fixed income account with an investment advisor is often a prudent investment decision. A separately managed fixed income account offers professional management, laddered individual bond portfolios, greater transparency, and tax efficient management.

In a rising rate environment, the net asset value (NAV) of the mutual fund falls as interest rates rise. Since a bond fund shareholder owns shares in a mutual fund instead of individual bonds, the bond fund investor may face a difficult choice; the shareholder either has to exit the fund or take the medicine as the value of the fund declines. In a fixed income mutual fund, there is uncertain repayment of principal.

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Often, bond mutual fund portfolio managers are forced to sell into a falling market to meet shareholder redemptions. For example, the mutual fund portfolio manager may be forced to sell higher quality bonds that are easier to sell, but leaves shareholders with riskier bonds. Recently, Waddell and Reed's Ivy High Income Fund sold some of its safest bonds to meet a wave of redemptions over the last year. As a result, the fund's holdings of the riskiest junk bonds, those rated CCC or lower, have grown to 47% of assets, from 35% before the redemptions.

Another example of lack of transparency in bond mutual funds is PIMCO's extensive derivative use in its funds. While the use of derivatives may help boost performance, derivatives can entail more risk, especially during periods of market stress. Because the derivatives that PIMCO uses are relatively opaque, it is hard to deduce the strategy by scrutinizing them directly. Examples of financial derivatives include interest rate futures, interest rate options and swaps, credit default swaps, and currency futures and swaps.

Similarly, Puerto Rico bonds are widely held by tax-exempt mutual funds. In late June/early July 2015, Puerto Rico was downgraded to Caa3 with a negative outlook by Moody's and CCC- by S&P as the governor asserted the need for debt restructuring. As a result, the S&P Puerto Rico Index has returned -9.36% year-to-date, as of July 1, 2015. However, according to Morningstar, more than half of tax exempt mutual funds still hold Puerto Rico Bonds. To meet redemptions, selling higher quality bonds, may leave mutual fund shareholders with higher exposure to lower quality bonds, like Puerto Rico.

At South Texas Money Management, one of our specialties is fixed income separately managed accounts. We are currently constructing fixed income portfolios (with a minimum fixed income allocation of $150,000) with short average maturity, individual bond ladders – staggering maturity dates so as to not get locked in to a particular maturity for a long time period, utilizing taxable or tax-exempt bonds, as appropriate. In the meantime, the investor is receiving steady income. In addition, we are buying short to intermediate individual bonds, which are less vulnerable to rising interest rates than longer bonds. At STMM, most of our purchases are in the new issue market, and there are no markups associated with those purchases.

We believe that most of an investor's acceptable level of "risk" should be taken in the equity portion of their portfolio. Therefore we focus on high quality for our fixed income strategy. Historically, high quality, short-term bonds have a very low correlation with equities. As a result, it helps to dampen the effect of volatility in portfolios since equities and high grade fixed income typically act as a hedge to one another. The average credit rating of our fixed income portfolios is "AA" or higher, and STMM will only purchase bonds with a rating of "A" or higher. Therefore, the risk of default in bonds that are purchased by STMM is minimized. We source bonds through our network of over 40 broker/dealers, representing many of the largest national and regional firms. After a bond is purchased, we have ongoing credit quality surveillance to ensure that bonds maintain our high credit quality guidelines. Additionally, our firm obtains competitive bids to sell a bond, if it is necessary to sell a bond for an objective change or for liquidity reasons. STMM offers professional management, full transparency, and tax efficient management. With almost $700 million in fixed income assets under management, STMM offers competitive returns with low volatility and low fees for fixed income oriented accounts.

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